Appendix R:
Additional Funds Transactions

I. Overview

A. **OMHAR Encourages AF Transactions.** OMHAR encourages the ownership entity to obtain additional funds. OMHAR expects that the main objective of the new sources of funds will generally be to achieve a greater level of up-front rehab than is possible under a standard M2M transaction. A portion of these additional sources may also pay for reasonable acquisition, TPA (transfer of physical asset) and other costs related to acquisition of the property. Use of these sources is subject to subsidy layering requirements. In general, OMHAR is willing for the additional funds to serve as increased sources, rather than to improve HUD's overall recovery – for example, to reduce the claim or to make payments on the Mortgage Restructuring Note (sometimes referred to as a M2M "2nd mortgage"). In this way, the owner (or ownership entity) benefits through its ability to raise additional, needed funds, and the property benefits when these are applied to the transaction.

B. **Additional Funds.** In the M2M program, sources of cash are generally limited to a new first mortgage, the claim payment, existing reserves, and a standard M2M owner contribution. Occasionally, a prospective purchaser or a stay-in owner (collectively – the ownership entity) may decide to pursue additional sources to accomplish their acquisition and rehab objectives. Examples of such sources include tax exempt bonds, CDBG funds, HOME funds and tax credits. These "additional funds" restructurings require additional steps in the underwriting process.

C. **Effect on M2M Owner / Purchaser Incentives.** Several of the M2M program's Owner and Purchaser Incentives are generally available only to non-AF restructurings. Other Incentives are generally tied to the use of Section 223(a)(7) financing approved by OMHAR. If other financing is used, items such as developer fees will be governed by the financing source's underwriting and closing requirements.

D. **OMHAR Permission to Pursue an AF Transaction.** As discussed in more detail in the step-by-step processing section below, the OMHAR Production Office will make a case-by-case determination whether to accept an AF transaction, or to pursue a normal restructuring. In general, OMHAR will agree to accept AF transactions provided that the transaction is reasonably likely to close in a timely manner and involves significant public benefits. The PAE can request OMHAR's approval of an AF transaction early in the due diligence process leading to restructuring. Such an approval would be conditioned upon the ownership entity obtaining the financing and other forms of assistance anticipated in the AF transaction.

E. **AF Transaction Can Occur After M2M.** Potential purchasers may wish to consider acquiring the property (prior to, at, or after the closing of the M2M restructuring) and then, after the M2M closing, executing a more extensive rehab with additional funds from other sources. Purchasers who plan to pursue this approach should consider whether they may want to refinance the new M2M first mortgage; if so the purchaser would need to find a lender willing to make the M2M first mortgage loan without the usual prepayment prohibitions.

II. Key Elements of Additional Funds Transactions

A. **Baseline Transaction.** The central concept in AF restructuring is 'the baseline transaction'. This is the standard M2M restructuring transaction (not involving additional funds) that OMHAR would usually be willing to close with the existing owner. The PAE will determine the parameters of the baseline transaction before considering an AF transaction. OMHAR will not pay a greater claim payment than derived from the baseline transaction, even if the projected Mortgage Restructuring Note recoveries are higher than in the baseline transaction.

B. **If Market Rents Increase.** Some AF transactions may involve rehab will result in higher market rents (see the additional discussion in item IV.C.4 below). For these transactions, the PAE will adjust the baseline to reflect the increased market rents, but will make no other adjustments (e.g., the baseline transaction will not reflect the additional rehab itself, or operating expense adjustments that correspond to the additional rehab, or any additional funds). The purpose of this adjustment is to ensure that savings to HUD will be the same in the baseline and AF transactions.

C. **Exception Rent Transactions.** If the baseline scenario requires exception rents, the same level of exception rents will be allowable for the AF transaction, subject to case-by-case review by the OMHAR HQ Loan Committee. Increased exception rents will not be allowed. The remainder of this Appendix assumes that the AF transaction utilizes market rents. Production Offices should contact OMHAR HQ to discuss AF transactions that may need exception rents.

III. Example

The chart below illustrates a sample AF transaction, as it progresses through underwriting.

- Stage One: Pre-restructuring, showing the property's large, unsupportable first;
- Stage Two: Baseline, showing the property's standard restructuring with the current owner – without the benefit of additional funds; and,
- Stage Three: In this example, a higher first mortgage is financed through tax-exempt bonds. The lower interest rate on the bonds allows for a greater first mortgage loan by $111,000. These funds can be used to increase the up-front rehab of the property.

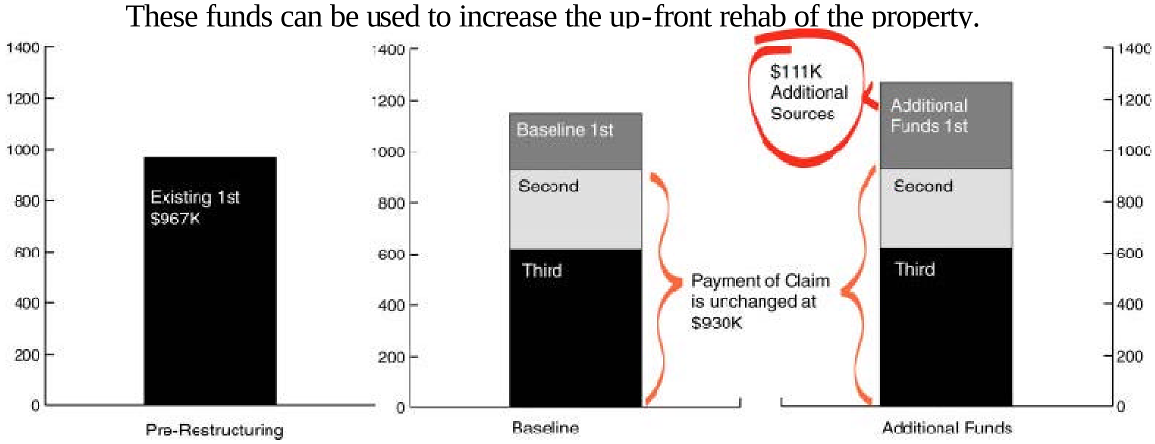

Figure 1. Illustrative Example: Additional Funds Provided by Tax Exempt Bond Financing

IV. Step-by-Step Process.

A. **Decide Whether to Accept the AF Transaction.** The PAE will make an initial evaluation of the proposed AF transaction to verify that it should be accepted. If at that time, or during later processing, the PAE questions whether the AF transaction should be accepted, the PAE should bring the transaction to the attention of the OMHAR Portfolio Director.

1. **Sources and Uses**. Obtain from the ownership entity a certified estimate of the total sources and uses for the proposed AF transaction, including disclosure of any amounts proposed to be paid to parties having an identity of interest with the ownership entity, and including sufficient detail to enable the PAE to determine the acceptability of the proposed AF transaction.

2. **Check for Key Elements**. In general, OMHAR encourages AF transactions subject to a favorable review of the elements outlined below.

   a) **Level of Additional Rehab.** In general, AF transactions should involve significant additional rehab.

   b) **Extension of Above-Market Rents**. In general, AF transactions should not require the extension of above-market rents for a longer period than would be necessary without the additional funds.

   c) **Likelihood of Closing**. In general, the AF transaction should be reasonably likely to close in a timely manner. The source of the additional funds should be documented, and there should be no other potential barriers to the closing of the AF transaction.

   d) **Level of Benefit**. In general, the additional funds should result in significant benefits to the residents and community and to the property's long-term economic and physical viability, by comparison to the baseline transaction. The addition of a community room or a Neighborhood Network program are examples of items benefiting the residents and the community.

3. **Lack of One or More Key Elements**. If the proposed AF transaction does not contain all of the key elements outlined in subsection 2, the PAE and the ownership entity should explore whether the proposed transaction can be modified to eliminate the problem. Additionally, OMHAR may be willing to accept the transaction if it is sufficiently attractive by comparison to OMHAR's alternatives (for example, to pursue restructuring without additional funds, or to be unable to complete a restructuring transaction).

4. **Subsidy Layering.** AF transactions must meet subsidy layering requirements. These requirements include a reasonableness review of the proposed uses of funds, and a review of compensation to all parties (including the ownership entity).

B. **Complete the Baseline Underwriting.** In practice, the baseline transaction must be underwritten without consideration of additional funds. The baseline underwriting assumes that the existing owner will close the restructuring and continue to own the property, even though, in reality, most additional funds transactions will involve new ownership bringing new resources. The PAE need not obtain actual financing proposals to document interest rates and transaction costs, but can instead use its market knowledge to create estimates In general, follow standard OMHAR underwriting practices:

1. **Market Rents and Expenses.** Typically, market rents will reflect the level of rehab normally required by OMHAR. Market rents in the baseline scenario may be increased to reflect rehab work to be completed with the additional funds if a market rate tenant would actually be willing to pay extra for the improvements and if the improvements meet the M2M program's "non-luxury" standard. See the discussion in C.4 below, and items II.A and II.B above.

2. **Rehab Escrow, IDRR, Residual Receipts, and on-going deposits to the Replacement Reserve.** Determine these according to normal M2M standards, without considering additional rehab to be undertaken with additional funds.

3. **Required Owner Contribution for Rehab, Escrow and Transaction Costs, CRP, IPF, DSCR, and 1st Mortgage.** Use normal M2M standards, except for transactions with small supportable first mortgage amounts. For these, the baseline underwriting should reflect a first mortgage, even if the principal amount is below $250,000 and even if standard underwriting, when considering transaction costs, would have deemed that no first mortgage was reasonable.

4. **No Workable Baseline Underwriting.** If a workable (baseline) transaction cannot be constructed using standard M2M resources, and without the benefit of the additional funds, the underwriter should attempt to come as close as the M2M resources allow to a workable transaction; in general, this will involve a full claim. This baseline transaction can include exception rents if the property meets exception rent eligibility criteria (see Section 5-12).

C. **AF Underwriting (In General).** See item (1) below regarding the underwriting model.

1. **Modeling AF Transactions**. Underwriting models version 4.0 and higher will accommodate AF transactions. First, complete the model for the baseline transaction and save it. This will provide a permanent record of the baseline transaction and will allow you to adjust the baseline later, if necessary. Using the completed baseline model, save a copy under a different filename for AF underwriting purposes. Then, engage the model's AF Transaction mode by using the button provided on the model's cover page (left-most worksheet) below the comment box. The button will take you to a special location on the Debt Service & Loan Sizing worksheet. Enter the amount of the Baseline Claim where indicated (enter numbers, not a formula). Then, proceed with Additional Funds data entries. The claim will remain at the baseline amount.

2. **Rehab Escrow.** This discussion addresses immediate rehab only; see also the later discussions of IDRR and the 20 year Reserve for Replacement schedule.

a) The proposed AF rehab schedule must include all items identified by the PAE for inclusion in the rehab escrow (i.e., the baseline OMHAR rehab), with costs for those items comparable to the costs estimated by the PAE.

b) The additional rehab (over and above the baseline) is reviewed for reasonableness as part of the PAE's subsidy layering analysis.

3. **Owner Contribution.** The PAE will verify that the owner is investing at least the amount required in the baseline transaction. Regarding the funding for the owner contribution:

   a) The owner investment for rehabilitation cannot be funded with by a loan secured by the property (MAHRA 517.c.1.B requires that the owner contribution be from non-project resources). Otherwise, funding may come from any non-project source.

   b) As in all other M2M transactions, of the 20% owner contribution for rehab, at least 3% must come from non-governmental sources. Tax credit equity is considered a non-governmental source.

4. **Market Rents**: OMHAR expects that the additional rehab in AF funds transactions generally will not change the market rents vs. the baseline transaction (if the market rents will change, the increase will be reflected in the baseline transaction as discussed above). However, OMHAR generally does not dictate how the ownership entity and additional funds provider apply the additional funds proceeds, and PAEs have the latitude to propose increases in the market rents as a result of the additional investments to be made by the ownership entity, but only if the PAE concurs that the improvements would increase the rent that a market tenant would be willing to pay. PAEs should discuss potential rent adjustments in advance with the OMHAR Production Office.

5. **Approval.** All AF transactions will require approval by the HQ Loan Committee. It is not necessary to seek separate approval for the baseline transaction. However, both the baseline and AF models must be submitted, and the HQ Loan Committee presentation would include a discussion of the baseline transaction (in particular, the claim amount, rents, savings, and supportable Mortgage Restructuring Note).

For AF transactions using §223(a)(7) financing, special considerations are addressed in section (D) below.

For AF transactions using other types of financing, and having Mortgage Restructuring Notes, see section (E) below for additional considerations. OMHAR generally will require a DSCR sufficient to support the same amount of Mortgage Restructuring Note as the baseline transaction.

D. **Additional Considerations for AF Transactions using §223(a)(7) Financing.** For these transactions, the PAE will fully underwrite the transaction and will establish the terms of the new §223(a)(7) financing for OMHAR's approval.

1. **Operating Expenses**: Generally, use the baseline operating expenses. However, the PAE may use expenses higher or lower than the baseline expenses to reflect additional rehab. For example, the addition of air conditioning would call for additional reserves, and would call for additional utility expenses if electricity is owner-paid.

2. **Proposed Rehab**. Note that there are limits on the amount of rehab that may be undertaken in the 223(a)(7) program. If "substantial rehabilitation" is involved (see Appendix N, paragraph C.4), 223(a)(7) financing may not be used.

3. **20 Year PCA Schedule**. Adjust the 20 year PCA schedule to reflect the AF rehab. For example:

    a) **Add Items**. For example, if the addition of air conditioning is included in the AF transaction but not in the baseline, add a new line item in the PCA schedule, for repair/replacement of the new air conditioning equipment when it reaches the end of its useful life.

    b) **Remove Items**. For example, the up-front replacement of gas furnaces (25 year useful life, scheduled for year 7 in the baseline) would call for the removal of furnace replacement from the PCA schedule (the first replacement would be beyond the 20 year window).

    c) **Shift Timing of Items**. For example, the up-front replacement of refrigerators scheduled for year 3 through 6 in the baseline would call for an adjustment to the PCA schedule, shifting the replacement to year 15 through 18.

4. **IDRR and Reserve Deposit.** Then, determine a new IDRR and Reserve Deposit according to normal M2M standards. The new amounts will often be lower, but may be higher, than the baseline amounts, depending on the nature of the additional rehab.

5. **DSCR**. Select a DSCR according to normal M2M standards.

6. **First Mortgage Amount**. The AF underwriting may result in a different supportable 1^{st} mortgage amount than in the baseline transaction.

7. **CRP**. If the additional funds include grants or Low Income Housing Tax Credits, set the CRP to zero. Otherwise, use the baseline CRP, even if the owner contribution will increase due to the higher transaction costs in the AF scenario.

8. **IPF**. Use the same dollar amount of IPF as the baseline transaction.

9. **Transaction Costs**. In most §223(a)(7) AF transactions, transaction costs will increase above the baseline. However, because the claim has been locked down, only the transaction costs that are included in the baseline transaction will be financed through the restructure. The baseline transaction costs should be hard-coded in the Sources & Uses page of the AF underwriting model. Use the AF Transactions Detailed S&U page of the model to reflect any differences in transaction costs, which will in most cases require an additional owner contribution.

E. **Additional Considerations for AF Transactions using financing other than §223(a)(7), and structured with Mortgage Restructuring Notes.**

1. **Purposes of AF Underwriting for non-§223(a)(7) Transactions**.
   a) Underwriting by PAE. This section requires the PAE to estimate how the property will perform, for the purposes noted in item (b) below. The PAE's underwriting for these transactions may differ from the underwriting of the new lender.
   b) Determinations Required. Even though a party other than the PAE is underwriting the post-M2M 1st mortgage, the PAE must determine that the Mortgage Restructuring Note:
      i) is reasonably likely to be repaid;
      ii) has a principal amount at least as large as in the baseline transaction; and
      iii) has a net present value to HUD at least as large as in the baseline transaction.

   Items (2) through (8) below detail how to make these determinations.
   c) Qualified Nonprofit Purchasers. If the Mortgage Restructuring Note is planned to be forgiven or assigned, the first determination ('likely to be repaid') is required by statute, but the remaining two determinations (principal amount and NPV) may be omitted.

2. **Operating Expenses**: If the AF lender's proposed expenses are reasonable (in total), the PAE may reflect the proposed expenses in the model. Alternatively, the PAE may use the baseline operating expenses, adjusted to reflect the effects of the additional rehab. For example, addition of air conditioning would call for additional maintenance and reserve expenses, and additional utility expenses if electricity is owner-paid.

3. **IDRR, Reserve Deposit, and 20 Year PCA Schedule.** The PAE will use the AF lender's proposed IDRR. The PAE will use the AF lender's proposed Reserve deposit only if it is adequate to cover all items on the 20 year PCA schedule (adjust the baseline schedule to reflect the effects of the AF rehab; see item D.3 above) without violating the M2M Reserve balance floor. If the AF Lender's proposed Reserve deposit is not adequate, the PAE must use a higher Reserve deposit amount that meets this requirement and should make the owner and AF lender aware that their proposed Reserve deposit is not adequate to fully fund the property's projected capital needs. The PAE must use an adequate Reserve deposit for purposes of making the 'likely to be repaid' determination, even if the AF transaction will actually go forward with a smaller Reserve deposit (otherwise the 'likely to be repaid' determination will not be accurate).

4. **1st Mortgage and DSCR**. The PAE will use the AF lender's proposed 1st mortgage terms, including debt service. The PAE does not need to evaluate the resulting DSCR; however the property's cash flow (as underwritten by the PAE) does need to be adequate to meet the tests described in items 6 and 8 below.

5. **CRP**. A CRP is not allowed if the AF transaction involves tax credits or grants or other soft debt without a fixed payment schedule.

6. **IPF**. Use the baseline IPF. OMHAR will require that the baseline IPF be included, and covered (as underwritten by the PAE), in all AF transactions structured with Mortgage Restructuring Notes.

7. **Residual Value**. PAEs may use a calculation higher than baseline if appropriate (for example, if the proposed first mortgage has a different term than the baseline first mortgage, or if the additional rehab will change the residual value).

8. **Size the Mortgage Restructuring Note.** Determine the 'reasonably repayable' Mortgage Restructuring Note amount based on the PAE's AF underwriting. Verify that the Mortgage Restructuring Note amount is at least as large as in the baseline, and that the net present value to HUD (of the projected Mortgage Restructuring Note payments, as underwritten by the PAE) is at least as large as in the baseline.

9. **If Mortgage Restructuring Note Is Below Baseline.** If the resulting Mortgage Restructuring Note amount (or NPV) is below the baseline, the PAE must inform the owner and AF lender that the transaction is not approvable, and the owner and AF lender must make a new proposal for the PAE's review and analysis. The new proposal must provide greater cash flow / debt service coverage (generally by reducing the new 1st mortgage debt service), in order to support an appropriately sized Mortgage Restructuring Note. The PAE should clarify that this is not a criticism of the AF lender's underwriting but instead is merely an observation that the resulting cash flow is not adequate to support the baseline Mortgage Restructuring Note.

F. **Restructuring Commitment (RC) Issues.**

1. **Sale Transactions**. The new financing may not materialize or the purchaser may not close. The RC should notify the seller / owner that, if the AF transaction fails, restructuring will be discontinued (and rents reduced to market) unless the seller / owner executes an RC acceptable to OMHAR and closes the resulting M2M transaction.

2. **Transaction Costs.** The RC should reflect the HUD share of transaction costs as being the HUD share in the baseline scenario. The owner share is the difference between that amount and the total transaction costs in the additional funds scenario.

3. **OMHAR-Required Rehab, If the M2M Rehab Escrow Agreement Will Not Be Used.** The RC should provide that the portion of rehab that is in the baseline transaction must be completed, and that this OMHAR-required rehab may not be modified or delayed without the advance written permission of OMHAR.

4. **Rehab That Increases Market Rents, If the M2M Rehab Escrow Agreement Will Not Be Used.** If the AF rehab includes items that justify increases in the Section 8 rents (or that are otherwise essential to OMHAR, for example rehab items that affect tenant utility allowances), the Restructuring Commitment should provide that this portion of the AF rehab must be completed, and that this rehab may not be modified or delayed without the advance written permission of OMHAR. The Restructuring Commitment should further provide that if this portion of the rehab is not completed (or is modified,

and OMHAR determines that the modification reduces the comparable market rents), the Section 8 rents will be reduced accordingly.